ORIGINAL

Before The
Federal Communications Commission
Washington, D.C. 20554

JAN 11 1996

In the Matter of	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket 94-1
Fourth Further Notice of Proposed Rulemaking	)	

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COMMENTS OF BELL ATLANTIC
ON THE FOURTH FURTHER NOTICE

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COMMENTS OF BELL ATLANTIC[1]
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I. Introduction and Summary

As demonstrated in the prior round of this proceeding and in Bell Atlantic's filing in the companion proceeding here, the existing price cap plan for local exchange carriers must be changed to accommodate the rapid change and increasing competition occurring in the telecommunications industry. The need for reform will become all the more acute with the passage of landmark telecommunications legislation that is now pending, the effect of which will be to so fundamentally alter the structure of the industry as to make divestiture pale in comparison.

In particular, the existing price cap scheme preserves a sharing requirement and other elements of rate of return regulation that are throwbacks to a bygone era, and actually serve

[1] The Bell Atlantic telephone companies include Bell Atlantic-Delaware, Inc., Bell Atlantic-Washington, D.C., Inc., Bell Atlantic-Maryland, Inc., Bell Atlantic-Pennsylvania, Inc., Bell Atlantic-New Jersey, Inc., Bell Atlantic-Virginia, Inc., and Bell Atlantic-West Virginia, Inc.

to undermine the Commission's goals. The interim plan now in effect also incorporates an inflated productivity offset that requires larger year-over-year price reductions than reasonably can be sustained into the future. The Commission here should correct these deficiencies, and adopt price cap rules that will more fully duplicate the incentives of a competitive marketplace. Doing so will encourage economically efficiency investment, promote competition, and help to preserve universally available, high quality services -- all to the benefit of consumers.

To achieve these objectives, the Commission should: a) eliminate sharing and other harmful vestiges of rate of return regulation; b) adopt a corrected, lower productivity offset that is in line with the total factor productivity gains actually experienced by the industry; and c) immediately remove services for which competitive alternatives are available, as well as new and discretionary services, from price cap regulation.

II. Eliminate Sharing and Other Harmful Vestiges of Rate of Return Regulation

The sharing and lower-bound adjustments, as well as other carryovers from rate of return regulation, are inconsistent with the Commission's price cap scheme and affirmatively harmful to the public interest. The Commission recognizes this fact, and has embraced the elimination of sharing as its "long term objective."[2] But in the telecommunications marketplace of today, the long term is now. The Commission should immediately eliminate sharing and its

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[2] Fourth Further Notice of Proposed Rulemaking, CC Dkt. 94-1 at ¶114 (rel. Sept. 27, 1995) ("FNPRM").

accompanying rate of return baggage, and adopt a pure price cap plan just as at least 19 states have already done.[3]

As Professor Alfred E. Kahn explained in a previous round of this proceeding,[4] and as the Commission has since concluded,[5] the sharing adjustment in the existing price cap plan undermines incentives to improve efficiency and to innovate, and deters investment in the nation's infrastructure. As a result, it undermines the very incentives that price caps were intended to create, and "deprives LECs and their customers of the full benefits of lower prices and improved efficiency that a pure price cap scheme can offer."[6] In fact, even MCI has criticized sharing as "completely inconsistent with the move toward effective competition."[7]

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3 See Affidavit of Richard J. Gilbert and Robert G. Harris at ¶ 25, attached to Comments of Bell Atlantic, CC Dkt. 94-1 (filed Dec. 11, 1995) ("Gilbert & Harris Aff.").

4 See Affidavit of Alfred E. Kahn, CC Dkt. 94-1 at ¶ 19 (filed June 29, 1994) (attached at Tab 1) ("So long as the price caps continue to be tested from time to time against the rate of return they produce...the perverse effects of cost-plus regulation on the companies' incentives will not be entirely eliminated." Id. at); see also Gilbert & Harris Aff. at ¶ 25.

5 Price Cap Performance Review for Local Exchange Carriers, 10 FCC Rcd 8961, ¶¶ 187-88 (1995) ("Performance Review Order")("We remain convinced that a rate-of return backstop reduces the efficiency incentives that can be generated by a pure price cap plan."); see also FNPRM, at ¶114 ("[T]he sharing mechanism blunts the efficiency incentives created by the price cap formula by diminishing the profits that LECs can achieve by reducing unit costs.").

6 Performance Review Order at ¶ 191; see also id. at ¶ 187 ("These reduced incentives can be expected to generate lower LEC efficiency, which in turn would reduce the benefits of price caps to consumers and the health of the national economy").

7 Petition of MCI Telecommunications Corp. for Implementation of Competition Plus: A True Price Cap for Maryland, at 18 (Md. P.S.C. filed Nov. 20, 1995).

In contrast, eliminating sharing in favor of pure price caps will provide incentives akin to those of a competitive market to improve efficiency and to innovate.[8] By allowing LECs to earn a return commensurate with the risk involved, pure price caps also will promote economically efficient investment, and ensure that the risk of this investment is borne entirely by shareholders.[9]

An added virtue of pure price caps is that, by severing any direct link between costs and earnings, it eliminates any conceivable need for other archaic holdovers from rate of return. For example, pure price caps eliminate any possible risk of cross-subsidy, and with it the need for burdensome and uneconomic cost allocation and pricing rules.[10] Pure price caps also

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[8] Kahn Aff. at ¶¶ 21-24 ("The extraordinarily great importance of innovation in telecommunications provides the strongest reason for eliminating all vestiges of rate base/rate of return regulation."); see also Performance Review Order at ¶¶ 188-89; Gilbert & Harris Aff. at ¶ 25.

[9] Kahn Aff. at ¶ 23-24 (pure price caps have the "virtue of placing on the shareholders of the private companies the responsibility and the risks of the major new investments required, along with the undiluted incentive to assume those risks..."); see also Performance Review Order at ¶ 189 ("A pure price cap plan, without earnings sharing, may also encourage infrastructure development and the deployment of advanced equipment and technology.").

[10] Kahn Aff. at ¶¶ 26-27 ("It is only the presence of rate base/rate of return regulation that creates the possibility of ...cross-subsidization;" "In its pure form, direct price regulation...eliminates any incentive of the regulated companies to shift costs from unregulated or competitive to less competitive services."); see also id. at ¶ 25 ("This danger in turn provides the rationale for regulators setting floors under the competitive prices...typically above incremental cost...and therefore at potentially inefficiently high levels.").

eliminate any conceivable justification for regulatorily prescribed depreciation rates, and "would free LECs to pursue economically correct depreciation policies."[11]

Eliminating these burdensome and one-sided constraints also will allow LECs to compete on an equal footing with long distance companies and other providers of competing access services that are not subject to price regulation, and with cable competitors who already benefit from pure price caps.[12] This, in turn, will provide consumers with the benefits of true competition.[13]

Moreover, the sharing adjustment and its accompanying baggage can no longer be justified. According to the Commission, sharing was intended as a "backstop" to protect against the possibility the Commission might miss the mark in its initial estimate of the productivity

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[11] Kahn Aff. at 13 ("Because prices would no longer be linked to earnings, measured by regulatorily prescribed accounting, the factors that have historically induced regulators to prescribe...unrealistically slow depreciation policies for such purposes would no longer apply. Once prices are capped, the adoption of faster depreciation rates thereafter would not affect prices but would instead come out of reported profits.").

[12] Under the pure price cap plan adopted for the cable industry, cable companies are not only free to set their depreciation rates, but also are free of burdensome cost allocation requirements except in the limited instances where they attempt to justify rates above the price cap level by filing a cost of service showing. See Implementation of Sections of the Cable Television Competition and Consumer Protection Act of 1992: Rate Regulation, 9 FCC Rcd 4119, 4124 (1994); Thirteenth Order on Recon., MM 92-266 (rel. Sept. 22, 1995) (further clarification of the rules governing annual price cap filings and cost of service showings).

[13] Kahn Aff. at 12 ("Pure price cap regulation has the additional great virtue of making it possible to relax the restrictions on the ability of utility companies to compete and so mitigates the distortions of competition that those restrictions entail.").

gains that would be achieved under price caps.[14] But the LECs have been subject to price caps for over four years, and evidence of real world productivity gains under price caps eliminates any justification for retaining a rate of return backstop -- particularly one based on meaningless measures of regulatory accounting earnings.[15] And this is all the more true given that far less harmful alternatives, such as the use of a rolling average measure of LEC productivity, can address any concerns that productivity might change appreciably in the future.[16]

Nor can sharing now be justified as a way to reflect differences in productivity gains achieved by individual companies.[17] This type of company-specific adjustment is inconsistent with the entire price cap scheme, which creates incentives to improve efficiency by rewarding companies that are most efficient, and by punishing laggards. The sharing and lower-

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14 See Policy and Rules For Dominant Carriers, 5 FCC Rcd 6786, ¶ 120 (1990) ("LEC Price Cap Order").

15 According to the Commission, the reason for the switch to price caps was to avoid reliance on earnings, precisely because it undermines efficiency incentives and depends on inherently arbitrary cost allocations. See Performance Review Order, 10 FCC Rcd at 9019-20, ¶ 129 & n.241; id. at 9034, ¶ 163. This is particularly true of accounting rates of return, which are not an accurate measure of productivity gains or economic performance. See, e.g., Affidavit of James H. Vander Weide at 5, ¶ 6 (attached to the Reply Comments of Bell Atlantic (filed June 29, 1994)). A far better measure is "economic" rate of return, which remained below the sharing threshold, was lower than in other comparable industries, and actually declined under price caps. Id. at 7, ¶ 8; USTA Ex Parte, The Price Cap LECs' Economic Rate of Return for the Price Cap Period at 2 & Table (Mar. 16, 1995); The USTA Response to MCI EBITDA Presentation at 2 & Table (Jan. 20, 1995); USTA Ex Parte, Response to CARE Ex Parte of November 4, 1994 at 2-3 (Nov. 29, 1994).

16 See supra, pp 9-10.

17 See FNPRM at ¶ 113.

bound adjustments, in contrast, punish the most efficient companies by denying them the full benefit of their labors, and reward the least efficient by providing a safety net to protect against their own poor performance.

III. The Commission Should Adopt a Corrected, Lower Productivity Offset for Services that Remain Subject to Price Cap Regulation

The interim productivity offset adopted in the Performance Review Order is out of line with the productivity gains historically achieved by the LECs, and that they reasonably can expect to sustain into the future. In fact, while the Commission has concluded that long term historical productivity gains are the best predictor of future gains,[18] the interim offset adopted for the pure price cap option is roughly double the long-term average.[19]

Retaining this inflated offset is contrary to the Commission's own public interest objectives.[20] For example, requiring larger year-over-year price reductions than are justified by experience creates a substantial disincentive to further investment. In addition, the

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18 See, e.g., Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd 2873, 2990, ¶ 224 (1989) (number based on "historical experience" will bear a "closer relationship to the level of productivity in the future" than would other measures), id. (use of a long term average avoids the swings in productivity that occur over shorter periods).

19 As the country's foremost productivity expert demonstrated in the Performance Review proceeding, the historical average of the productivity gains actually experience by the LECs was just 2.3 percent. See Christensen, et al., Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation, 1993 Update, CC Dkt. 94-1 (filed with USTA ex parte Jan. 20, 1995). The productivity offset for the pure price cap option, however, currently stands at 5.3 percent.

20 See, e.g., Robert G. Harris, Economic Benefits of LEC Price Cap Reform, CC Dkt 94-1 at 25 (filed May 9, 1994).

uneconomically large cost reductions needed to keep pace would risk jeopardizing continued high service quality, and undermine universal service objectives by making it all the more difficult to serve high cost areas. And while efforts to improve productivity in recent years have led to job cuts by the tens of thousands, this trend cannot continue indefinitely.

Moreover, setting the offset at a level higher than is justified by experience creates no additional incentive to improve efficiency. If LECs are allowed to retain the benefits of increased productivity, they already have every reason to become more efficient. Improving efficiency offers the possibility of higher profits, regardless of the level of the offset. Increasing the offset adds nothing to the existing profit motive. On the contrary, to the extent it discourages investment in productivity-enhancing technologies, an excessive offset will act as a damper on future efficiency gains.

A. The Commission Should Adopt a Single Productivity Offset Based on a Moving Average of the Industry's Actual Historical Total Factor Productivity

The Commission has long recognized that total factor productivity is the "superior productivity measure,"[21] and has correctly concluded that it is the correct productivity measure for use in setting a new offset here.[22] In fact, it is essentially the same method used by the

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21 See Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd 2873 at ¶ 206.

22 FNPRM at ¶ 25.

Bureau of Labor Statistics to track productivity trends on behalf of the U.S. government.[23] And the only concerns expressed by the Commission about relying on this productivity measure are addressed by using a simplified method developed by Dr. Christensen computing total factor productivity, and by using a five year moving average [24]

For example, the Commission noted that a few pieces of the data used in Dr. Christensen's previous study are not publicly available, and that updating a moving average based on that study potentially could become burdensome.[25] To address this concern, the simplified approach relies entirely on publicly available data.[26] To the extent substituting this publicly available data has any effect on the results of the study, it actually serves to increase the offset.[27]

Moreover, any concern that LEC productivity might change in the future is addressed by use of a moving average to calculate an offset. As the Commission itself recognizes,[28] use of a moving average of total factor productivity gains will capture any meaningful trends in productivity, and eliminates any conceivable reason for retaining the

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23 See Christensen, et al., Total Factor Productivity Methods for Local Exchange Carrier Price Cap Plans at vii, 2 ¶ App. A (Dec. 1995) (submitted on behalf of USTA in this proceeding) ("Christensen Study").

24 See Christensen Study at i-vii.

25 FNPRM at ¶¶ 17-18, 25.

26 Christensen Study at i-ii, 2.

27 Id. at iv-v, 8-9, 19-20, 24-25.

28 FNPRM at ¶ 96-97.

counter-productive sharing mechanism. And use of a five year period to calculate the rolling average will capture any meaningful trends, but generally avoid the extreme volatility caused by any shorter period.[29] The simplified approach developed by Dr. Christensen is specifically designed to allow such a rolling average to be readily calculated.[30]

Finally, establishing a single productivity offset based on an industry-wide average will force LECs to effectively compete against one another to become more productive. To achieve better than average profits and distinguish themselves in the eyes of investors, LECs must achieve better than average productivity -- just as they must in a competitive market. Over time, this competition to get ahead of the pack will act to keep the industry average at the maximum level the market can sustain, with consumers reaping the benefits. On the other hand, creating multiple offsets would undermine the LECs' incentives to beat the industry average.

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[29] As the FCC has recognized, the shorter the term of the study, the more susceptible it is to being skewed by abnormal fluctuations in a single year. See LEC Price Cap Order, 5 FCC Rcd at 6798, ¶ 97.

[30] Christensen Study at ii (simplified model can be "updated and verified in a straightforward manner").

In sum, the simplified approach creates a "proper balance between precision in measurement and verifiability,"[31] and should be used to set a single productivity offset based on a five year moving average. This produces an initial offset of approximately 2.8 percent.[32]

B. The Commission Should Not Include an Input Price Differential, Consumer Productivity Dividend, or Other Adjustments to Total Factor Productivity

The notice in this proceeding recites a number of possible adjustments to total factor productivity; each is flawed in material respects and must be rejected.

First, the notion that total factor results should be adjusted upward to reflect a supposed "input price differential" is contrary to the Commission's approach to setting an offset for AT&T,[33] and is demonstrably wrong for the LECs. As shown by Dr. Christensen and others, there is no meaningful differential over the long term between input prices for the LECs and the U.S. economy as a whole.[34] Although year by year fluctuations produce differences over short

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[31] Christensen Study at vii; see also Declaration of Melvyn A. Fuss at ¶ 5 (Dec. 15, 1995) ("I strongly endorse the use of direct TFP measurement in the calculation of the productivity offset in the FCC's price caps formula;""[T]he simplified TFP calculation remains economically meaningful and therefore useful and appropriate in establishing the productivity offset.") ("Fuss Decl.") (attached at Tab 2).

[32] This figure is computed by deducting the five year rolling average of U.S. productivity from the rolling average calculated by Dr. Christensen for the LECs. See Comments of USTA, CC Dkt 94-1 at 3 (Dec. 1995)

[33] Revision to Price Cap Rules for AT&T Corp., 10 FCC Rcd 3009, 3020-22, ¶¶ 33-35 (1995).

[34] Christensen Study at App. 3; NERA, Economic Evaluation of Selected Issues From the Fourth Further Notice at 2-14 (Dec. 18, 1995); see also Christensen, An Input Price Adjustment Would Be An Inappropriate Addition to the LEC Price Cap Formula, CC Dkt 94-1 (submitted with USTA Ex Parte Feb. 1, 1995).

periods, some of which are positive and some negative, these fluctuations do not alter the long term trends.[35] As a result, the sole effect of adding an input price differential would be to add volatility to the offset and create large year-by-year price swings that are disruptive for carriers and customers alike.

Moreover, the suggestion that the long term trend in input prices permanently changed at the time of divestiture -- so that LEC input prices now grow more slowly than the economy as a whole -- also is mistaken.[36] As the expert studies show, there is no statistically significant difference in the long term input price trends regardless of the time period examined, whether pre- or post-divestiture.[37] In fact, detailed statistical analyses, including the attached study by Dr. Melvyn Fuss, demonstrate that any short term fluctuation that may have occurred in the years immediately following divestiture had reversed itself by 1990.[38] And because history shows that short-term differences in one direction are offset by subsequent short-term differences

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[35] Id.

[36] FNPRM at ¶ 57; Performance Review Order at App. F.

[37] Christensen Study, App. 3 at 48-50 ("Statistical tests found there was no evidence that the input price trends differ for the telephone industry and the U.S. economy for the full 1948-1992 period. It is extremely important to note that the same conclusion holds for the 1948-84 and 1984-1992 subperiods."); NERA Study at 3-6.

[38] Fuss Decl. at ¶ 7 ("A more complete analysis than that carried out in Appendix F demonstrates that, assuming an input price differential developed after 1984, the correct conclusion is that the differential was a temporary phenomenon that ended in 1990."); Christensen Study, App. 3 at 49 & Charts 5, 6 ("Events since 1989 indicate the differential has resumed its long-term pattern of random, volatile deviations around zero."); NERA Study at 9 & Fig. 1 ("[T]he evidence suggests that a one-time deviation from historical norms has reversed itself;" "If there was a shift, it was temporary and is now over.").

in the opposite direction, adjusting the productivity offset upward based on perceived fluctuations in the input price differential during the 1980s would actually adjust the offset in the wrong direction.[39]

Second, a consumer productivity dividend cannot be added to the total factor productivity results. The Commission originally added such a dividend on the theory that LECs were expected to become more productive under price caps than they had been under rate of return.[40] But now the LECs have been subject to price caps for over four full years, and the Commission has held that actual productivity experience under price caps is the best predictor of future gains.[41] This experience eliminates any conceivable rationale for adding an arbitrary increment to the gains the LECs historically have been able to achieve. And this is all the more true if the Commission adopts a rolling average measure of productivity, since a rolling average will capture any future trends in LEC productivity.

Third, the Commission correctly recognizes that productivity cannot be adjusted to reflect less than total company results -- whether to derive a separate productivity figure for

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39 Christensen Study at 50.

40 LEC Price Cap Order, 5 FCC Rcd at 6799, ¶ 100; see also Policy and Rules Concerning Rates for Dominant Carriers, 3 FCC Rcd at 3407-09, ¶ 386.

41 See FNPRM at ¶95; Performance Review Order, 10 FCC Rcd at 9047, ¶ 191 ("[T]he performance of the LECs over the last four years of price cap regulation provides us with more reliable and accurate information with respect to efficiency gains that LECs reasonably can be expected to achieve...." (emphasis added)); id. at 9047, ¶ 190 ("[A]fter four years of experience with LEC price caps, we are in a much better position to set reasonable [offsets], using actual LEC performance data under price cap regulation. We no longer have to estimate their prospective performance under price caps." (emphasis added)).

just interstate services or for just regulated services.[42] In a joint use network where a variety of services share costs in common, any attempt to divide the common costs among these services is inherently arbitrary and will inevitably skew the productivity results.[43] It simply is not possible to magically divide the LECs' networks into two pieces and declare one more or less productive than the other.

C. The Commission Should Eliminate the Separate Carrier Common Line Adjustment Formula

The Commission also should modify its price cap formula to eliminate the separate common line adjustment formula.

As the Commission itself recognizes,[44] Dr. Christensen's total factor productivity studies already take common line growth into account.[45] Unlike the studies relied on when the current plan was adopted, therefore, the use of total factor productivity studies eliminates the need for a separate common line adjustment.

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42 FNPRM at ¶ 63.

43 NERA Study at 14-22. Because the Commission's Part 36 separations rules and its Part 64 joint cost rules require arbitrary and uneconomic assignments of common costs between services, they do not provide an adequate basis on which to compute separate productivity figures. Id.

44 FNPRM at ¶ 132.

45 See Christensen, et al., Productivity of the Local telephone Operating Companies, CC Dkt 94-1 at iii (May 1994) (submitted in support of USTA in Performance review proceeding), NERA, Economic Performance of the LEC Price Cap Plan, CC Dkt 94-1 at 3 (June 1994) (same).

Even if this were not the case, however, the Commission cannot abandon the current 50/50 common line formula in favor of a per line formula.[46] The sole argument for doing so is the claim that LECs have no control over common line growth and should receive none of the benefits. But the Commission previously rejected this very argument,[47] and there is no basis for an about-face today. On the contrary, with the deployment of new network capabilities and the introduction of new service, the LECs' ability to influence common line growth is even greater now than in the past.

IV. Proposed Alternatives to Total Factor Productivity Are Inferior And Should Be Rejected

While the notice in this proceeding cites a number of alternative methods of computing productivity, they each are flawed in significant respects and are inferior to total factor productivity.

The alternative that suffers from the most egregious flaws is AT&T's rate of return proposal, newly renamed the "historical revenue" approach.[48] By setting the offset to produce a specific rate of return, AT&T proposes to completely abandon incentive regulation in favor of a full-scale retreat to rate of return -- plain and simple.[49] It proposes to do so, moreover,

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46 FNPRM at ¶ 132.

47 See LEC Price Cap Order, 5 FCC Rcd 6786, at ¶¶ 69, 73.

48 FNPRM at ¶¶ 77-78.

49 As a result, AT&T's proposal would reintroduce all the harmful incentives the Commission sought to avoid by abandoning rate of return. NERA Study at 23-27.

specifically to recapture any improvement in profits that may have been experienced by the LECs, and to implement its proposal based on economically meaningless regulatory accounting earnings.[50] This result is directly at odds with the entire rationale for price caps, which create an incentive to improve efficiency by allowing carriers to benefit from higher profits and by requiring them to absorb lower profits.[51] And adjusting the offset based upon historical earning performance is a result that was expressly rejected by the Commission in AT&T's own price cap review proceeding.[52]

The "historical price" method used in the Frentrup-Uretsky studies, on the other hand, is not a direct measure of productivity.[53] As a result, it is an inferior measure of

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50 See supra note 5; see also NERA Study at 23-27.

51 LEC Price Cap Order, 5 FCC Rcd at 6789, ¶ 22 ("Carriers that can substantially increase their productivity can earn and retain profits at reasonable levels above those [under rate of return]."); id. at 6801,¶ 120 (price cap plan designed to offer LECs "a fair opportunity to earn higher profits"); Treatment of LEC Tariffs Implementing SFAS 106, 8 FCC Rcd 1024, 1025, ¶ 7 (1993) ("Carriers that are able to generate productivity gains in excess of the target will generate earnings higher than those experienced under rate of return regulation.").

52 As the Commission there explained: "[I]t is also crucial to avoid changes to the productivity factor that might undercut the incentives price caps seek to create. Under price caps, the incentive is based on profitability. AT&T is rewarded with higher profits if it achieves productivity growth above the target, and penalized with lower profits if it falls short. For this incentive to work properly, the productivity factor should not be changed either to recapture all profits, or to increase relatively low profits retroactively." AT&T Price Cap Review Order, 8 FCC Rcd 6968, at ¶ 21 (1994).

53 FNPRM at ¶ 32; LEC Price Cap Order, 5 FCC Rcd at ¶ 97.

productivity performance and is not an adequate basis on which to establish a productivity offset. In fact, it was for this very reason that the Commission refused to rely solely on such a study as the basis for establishing an offset in the original LEC price cap plan.[54]

And the so-called "direct" method used in the railroad industry is the economic equivalent of adding an input price differential to total factor productivity, and suffers from the same problems.[55]

V. The Commission Should Remove Competitive, as well as New and Discretionary Services From Price Cap Regulation

The further notice also asks whether different productivity offsets should be adopted that vary with the level of competition faced by individual services. As Bell Atlantic recently demonstrated in the companion proceeding in this docket,[56] however, subjecting competitive services to any continued price regulation will serve to inhibit the introduction of new and innovative services, and hamper the ability of LECs to compete. Instead, the Commission should remove competitive services, as well as new and discretionary services, from price cap regulation entirely and allow the marketplace to determine the appropriate price.

First, the Commission should remove from price regulation any services for which competitive alternatives are available. As the Commission itself has recognized, where

54 LEC Price Cap Order, 5 FCC Rcd 5786, at ¶ 99.

55 See supra pp. 10-12.

56 See Comments of Bell Atlantic, CC Dkt Nos. 94-1, 93-124, 93-197 (filed Dec. 11, 1995) ("Bell Atlantic Streamlining Comments").

competition is present, regulation should end.[57] And it is the presence of competitive alternatives that constrains the exercise of market power; with alternatives available, attempts to increase price will merely encourage customers to switch service providers.[58]

As demonstrated in previous pleadings, a number of existing services already fall within this category today. For example, over two-thirds of the demand for Bell Atlantic's high capacity access services already comes from areas with competitive alternatives available, and video dial tone services will face competing alternatives everywhere they are offered.[59] Likewise, services in the interexchange basket and operator services face competition from long distance companies such as AT&T, MCI and Sprint.[60] As a result, these services should be removed from price regulation immediately. And if immediate relief is not forthcoming, these services should be moved into a separate price cap basket with an offset equal to the one that applies to competing providers, i.e., zero.[61]

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57 Price Cap Performance Review for Local Exchange Carriers, 9 FCC Rcd 1687, at ¶ 92 (1994) ("[R]egulatory constraints...become unnecessary or counterproductive when market forces generated by competition effectively assure reasonable...rates."), id. ("Rate regulation in these circumstances may impede the incumbent carrier's ability to compete vigorously rather than protecting consumers.").

58 Bell Atlantic Streamlining Comments at 16; Kahn Aff. at 12-13; Gilbert & Harris Aff. at 13.

59 Affidavit of Richard E. Beville in Support of Comments of Bell Atlantic at ¶ 3 & Exhs. 1 & 3, CC 94-1 (filed May 9, 1994).

60 See Price Cap Order, 5 FCC Rcd 6786, ¶ 207 (holding that interexchange basket is competitive); Bell Atlantic Streamlining Comments at 23-24 & Tab 3 (demonstrating that operator services is competitive).

61 Id.; Performance Review, Order 10 FCC Rcd 8961,¶ 249 (1995).

Second, the Commission should remove all new and discretionary services from price cap regulation, regardless of the level of competition faced by those services.[62] This step will provide LECs the necessary incentives to provide innovative services that consumers want. Moreover, consumers will remain fully protected since they can simply elect not to buy these services, and setting prices too high will merely promote competitive entry in any event.[63] And if the Commission believes that any new mandatory interconnection services for competitors are a special case that should remain subject to price regulation to prevent increases,[64] then the simple solution is to carve this narrow class of services out for different treatment-- not to impose heavy regulatory burdens on all new services.

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62 Bell Atlantic Streamlining Comments at 11-15; Kahn Aff. at 14; Gilbert & Harris Aff. at 4-8.

63 Id.

64 Bell Atlantic Streamlining Comments at 13, n.43.

CONCLUSION

The Commission should modify the price cap plan for local exchange carriers in the respects identified above, and in Bell Atlantic's filing in the companion proceeding in this docket.

Respectfully submitted,

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AFFIDAVIT OF ALFRED E. KAHN

I. BACKGROUND, QUALIFICATIONS AND SUMMARY

(1) My name is Alfred E. Kahn. I am the Robert Julius Thorne Professor of Political Economy, Emeritus, at Cornell University and Special Consultant to National Economic Research Associates, Inc. My business address is 308 North Cayuga Street, Ithaca, New York 14850.

(2) Among the experiences of mine most pertinent to my submission in this proceeding are that I was Chairman of the New York State Public Service Commission between 1974 and 1977 and of the Civil Aeronautics Board in 1977-78; I am the author of the two-volume The Economics of Regulation, published originally by John Wiley & Sons in 1970 and 1971 and reprinted in 1988 by The MIT Press; I have written and testified extensively on the subject of telecommunications regulatory policy and published a book and numerous articles on antitrust policy. I was a member of the Attorney General's National Committee to Study the Antitrust Laws and the National Commission for the

Review of Antitrust Laws and Procedures. I have been advisor on telecommunications policy to Governor Carey, of New York State, and recently completed service as a member of the Ohio Blue Ribbon Panel on Telecommunications Regulatory Reform and of the New York State Telecommunications Exchange. I attach a copy of my full résumé as an Appendix to this affidavit.

(3) In its consideration of possible refinements and revisions of the rate caps to which Bell Atlantic is subject, which constitute the specific subject of this proceeding, I suggest it is essential that the Commission bear in mind its broader policies for the reform of telecommunications regulation generally, of which the imposition of rate caps has been an important component. The purpose of this submission is--at the risk of telling the Commission things it already knows and reminding it of the policies on which it has already embarked--to place the specific issues raised by the several parties in the broader context of the rapid and fundamental changes that are taking place in the telecommunications industries and the consequent urgent need for continued reform of the way in which it is regulated.

II. THE DEVELOPING COMPETITION IN TELECOMMUNICATIONS

(4) The telecommunications industry is undergoing rapid, fundamental transformation, a transformation extending to what has until recently been the very core of franchised monopoly, the local exchange network and local service. The imminence of ubiquitous competitive challenges to the LECs from cable television companies is the most recent and perhaps most dramatic development: by 1992 their coaxial cable already passed some 93 percent of all American households and their subscribers constituted about 58 percent;[1] and they are clearly planning, often in collaboration with others, to convert their systems to offer two-way switched services. The most striking of these alliances have been with out-of-territory telephone companies--US West's investment in Time Warner, Southwestern Bell's acquisition of the cable properties of Hauser and Bell Canada's investment in Jones Intercable--with the LECs combining their capital and expertise with

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[1] "Statistical Abstract of the United States 1993," U.S. Department of Commerce, p. 55 and "Kagan Media Index Historical Data Base," March 23, 1994, p. 10. According to NCTA, cable now passes some 97 percent of all television households and serves over 63 percent. Cable Television Developments, April 1994, 1-A.